Stepping up Again

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If you already read our coverage of the step transaction doctrine in this issue (*Don't Forget the Step Transaction Doctrine,* on page 1), wait! If you thought applying the step transaction doctrine to a bargain sale (charitable contribution) transaction sounded unusual, think again. Here's another recent case, this time applying the step transaction doctrine to collapse gift and sale transactions in an LLC. The case is *S.J. Pierre*, 99 TCM 1436, Dec. 58,217(M), TC Memo. 2010-106. One piece of the *Pierre* case was already the subject of a prior Tax Court opinion. [133 TC —, No. 2.]

Suzanne Pierre organized the Pierre Family LLC in 2000. In the same year, she created two trusts for her son and granddaughter (Jacques and Kati). Also in 2000, she transferred $4.25 million in cash and publicly traded securities to Pierre LLC in exchange for a 100-percent interest in the LLC. Twelve days later, she transferred her interest in Pierre LLC to the two trusts for Jacques and Kati. Suzanne Pierre then transferred (as a gift) a 9.5-percent interest in Pierre LLC to each trust.

Then she sold a 40.5-percent interest in the LLC to each trust in exchange for a promissory note. Each promissory note had a face amount of $1,092,133. The notes stated a 6.09-percent interest rate, were payable in 10 annual installments, and were secured by the interests in the LLC. The LLC made distributions to the trusts so the trusts could make the annual interest payments. No principal payments were made between 2000 and 2009.

The Gift

Suzanne Pierre filed a gift tax return for 2000, reporting the gift of the 9.5-percent LLC interest to each trust. By multiplying the 9.5-percent interest by the $26,965 appraised value of a one-percent nonmanaging interest in Pierre LLC, Suzanne reported the value of the taxable gift to each trust as $256,168. These values were then discounted significantly for lack of marketability and control.

The result was she paid no gift tax on the transfers after applying the unified credit. The IRS determined that the gifts of the 9.5-percent interests should be valued at $403,750 each, and assessed a deficiency. Plus, the IRS determined that Pierre had made indirect gifts of 40.5 percent of the assets of the LLC to each trust. This, after all, was one integrated whole.

Stepping Through the Cases

The Tax Court bifurcated the issues in the case. In the first case (133 TC —, No. 2 (2009)), the Tax Court held that the transfers had to be valued as transfers of interests in Pierre LLC. For that reason, the Tax Court sustained the applicability of discounts for lack of control and lack of marketability. That was an important case of first impression, since the LLC was treated as a disregarded entity under the check-the-box regulations.

Despite the check-the-box disregarded entity status, the Tax Court rejected the IRS argument that these transfers should be valued as transfers of the proportionate shares of the underlying assets owned by the LLC. This was still an LLC.

IRS's Second Try

In Tax Court a second time, the question was whether the step transaction doctrine should apply to collapse the gift and sale transfers. Collapsing them together would mean this was a transfer of two 50-percent interests in Pierre LLC. Predictably, Mrs. Pierre argued that each of the four transfers of her entire interest in the LLC had an independent business purposes. She listed nontax reasons for establishing the LLC, but no nontax reasons for splitting the gift transfers from the sales transfers.

Equally predictably, the IRS argued that the goal all along was to transfer a 50-percent interest in Pierre LLC to each of the two trusts. Dividing the transfers into four was only to avoid gift tax, the IRS claimed. The Tax Court had to agree.

Nonstatutory Mixing Bowl

The Tax Court examined the step transaction authorities, but did so by invoking the substance-over-form doctrine. Acknowledging the legal concepts, the Tax Court nevertheless said that the question of whether several transactions should be considered integrated steps of a single transaction is a question of fact, not a question of law. How did the facts here stack up?

The transfers all occurred on the same day. Plus, virtually no time elapsed between them. Mrs. Pierre gave away her entire interest in Pierre LLC within the time it took for four documents to be signed. There was also overall intent. There was evidence she intended to transfer her entire interest to the trust without paying any gift taxes.

In fact—all you advisors out there should gulp when you read this one—one of her advisors recorded the transfers as two gifts of a 50-percent interest in Pierre LLC. The advisor later testified that these records contained inaccuracies—including his characterization of the transfers. Despite that falling-on-his-sword explanation, it was a telling "error." The court said it could not easily ignore this contemporaneous description of the transaction. Ouch!

Determining that Mrs. Pierre intended to transfer two 50-percent interests to the trusts, the court noted that she first gifted small interests in the LLC to use a portion of her then-available unified credit. The court specifically found that she had primarily tax-motivated reasons for structuring the gift transactions as she did. The sale transactions for the promissory notes were then significantly discounted using a 36.55-percent valuation discount.

Rearview Mirror

Subsequent activity was also telling. Although interest payments were made, no principal payments were made on the notes, despite the passage of eight years. Furthermore, the cash flow was unimpressive. The LLC itself made yearly distributions to the trusts so that the trusts could make the yearly interest payments.

The net effect was that Mrs. Pierre transferred $4.25 million of assets within the LLC without paying any gift tax. In a telling rebuke, the Tax Court said that she intended not merely to *minimize* her gift tax liability, but to eliminate it *entirely*! Nothing of tax-independent significance occurred in the moments between the gift transactions and the sale transactions, found the Tax Court. The gift and sale transactions were planned as a single transaction, with multiple steps used solely for tax purposes.

All was not lost, though. After upholding the IRS invocation of the step transaction doctrine, the Tax Court considered whether the lack of control and marketability discounts Mrs. Pierre had reported should be reduced. Weighing the evidence, the court found there should be a slight reduction in the lack of control discount, but no reduction in the discount for lack of marketability.

Conclusion

A good defense to a step transaction assertion is a legitimate nontax reason for doing something. In fact, ideally you want nontax reasons for doing every single element. Even if five “steps” you take might be designed to achieve one ultimate result, you want to have reasons for doing them as discrete elements, with each one having independent significance. “Steps,” of course, is a word best avoided.

These days, with all of the focus on economic substance, it pays to remember these step transaction fundamentals. Any adviser knows there are often multiple reasons for every decision. Try not to focus myopically on one, especially if it is a federal income tax reason. You often will not have to dig too hard to uncover the multiple reasons a transaction makes sense. It’s clearly better to do that before a transaction, not after, and certainly not long after. It’s never as credible when you’re looking back.

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